



STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

Date Amended:	5/12/03	Bill No:	AB 783
Tax:	Property	Author:	Maddox and Mountjoy
Board Position:		Related Bills:	AB 2662 (2002) AB 1559 (1999)

BILL SUMMARY

This bill would provide that the phrase "course of construction" includes, but is not limited to, filing an application for a building permit with an appropriate local agency for purposes of qualifying for the property tax welfare exemption.

Summary of Amendments

The amendments to this bill since the previous analysis modify the expansion of the phrase "course of construction" to include, but not be limited to, filing an application for a building permit, in order to narrow the scope of the bill. Previously, the phrase was defined to include activities that are necessary for construction, such as seeking permits, environmental studies, government entitlements and approvals, financing, and contractors.

ANALYSIS

Current Law

Under existing law, vacant or unused property of a nonprofit organization that is held for a future use is not qualified for exemption from property tax, even if the intended use will be for exempt purposes and activities. However, the constitution has been amended to specifically provide that three exemptions can be granted to **"buildings under construction,"** land required for their convenient use, and equipment in them if the intended use would qualify the property for the exemption. Those exemptions are:

- **College Exemption.** Buildings, land, equipment, and securities used exclusively for educational purposes by a **nonprofit institution of higher education.** *Section 3(e) of Article XIII (Under construction provisions added by Proposition 14, November 2, 1954)*
- **Church Exemption.** Buildings, land on which they are situated, and equipment used exclusively for **religious worship.** *Section 3(f) of Article XIII (Under construction provisions added by Proposition 9, November 2, 1954)*
- **Welfare Exemption.** Property used exclusively for **religious, hospital, or charitable purposes** and owned or held in trust by corporations or other entities (1)

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that are organized and operating for those purposes, (2) that are nonprofit, and (3) no part of whose net earnings inures to the benefit of any private shareholder or individual. *Section 4(b) of Article XIII (Under construction provisions added by Proposition 15, November 2, 1954)*

Currently, these provisions are found in Section 5 of Article XIII of the California Constitution. With respect to the welfare exemption, the provisions of Section 5 are statutorily embodied and expanded upon in Revenue and Taxation Code Sections 214.1 and 214.2. Section 214.1 provides that the welfare exemption is available to **facilities in the course of construction**, together with the land on which the facilities are located as may be required for their convenient use and occupation.

Section 214.2 specifies that "facilities in the course of construction" require activity connected with the construction or rehabilitation of a new or existing building or improvement that **results in physical changes visible to any person inspecting the site** where the building or improvement is located. (A court has held that the phrase, "in the course of construction," as used in Section 214.1, includes the digging of trenches for the foundation of a building prior to the lien date.¹) As long as construction has commenced, the property will be considered "under construction" unless the construction is abandoned. However, if there is a delay in construction due to reasonable causes and circumstances beyond the property owner's control and that occurs notwithstanding the exercise of ordinary care and the absence of willful neglect, then the construction will not be considered "abandoned."

Section 214.2 further provides that "facilities in the course of construction" will include the demolition or razing of a building with the intent to replace the building with a facility to be used exclusively for religious, hospital or charitable purposes.

Proposed Law

This bill would amend Section 214.1 of the Revenue and Taxation Code to provide that the phrase "course of construction" includes, but is not limited to, filing an application for a building permit with an appropriate local agency.

In General

Welfare Exemption. Under Section 4(b) of Article XIII of the California Constitution, the Legislature has the authority to exempt property (1) used exclusively for religious, hospital, or charitable purposes, and (2) owned or held in trust by nonprofit organizations operating for those purposes. This exemption from property taxation, popularly known as the *welfare exemption*, was first adopted by voters as a Constitutional Amendment on November 7, 1944. With this amendment, California became the last of 48 states in the country to provide such an exemption from property taxes. The ballot language in favor of the amendment stated:

¹ *National Charity League v. County of Los Angeles* (1958) 164 Cal.App.2d 241.

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These nonprofit organizations assist the people by providing important health, citizenship and welfare services. They are financed in whole or in part by your contributions either directly or through a Community Chest. It is good public policy to encourage such private agencies by exemption rather than to continue to penalize and discourage them by heavy taxation.

When the Legislature enacted Section 214 of the Revenue and Taxation Code to implement the Constitutional provision in 1945, a fourth purpose, *scientific*, was added to the three mentioned in the Constitution. Section 214 parallels and expands upon the Constitutional provision by exempting property used exclusively for the stated purposes (religious, hospital, scientific, or charitable), owned by qualifying nonprofit organizations if certain requirements are met. An organization's *primary* purpose must be either religious, hospital, scientific, or charitable. Whether its operations are for one of these purposes is determined by its activities. A qualifying organization's property may be exempted fully or partially from property taxes, depending on how much of the property is used for qualifying purposes and activities. Section 214 is the primary welfare exemption statute in a statutory scheme that consists of more than 20 additional provisions. Over the years, the scope of the welfare exemption has been expanded by both legislation and numerous judicial decisions.

Owned and Operated Requirement. Section 214 requires that, to be eligible for the welfare exemption, both the owner and the user of a property must meet specific requirements. The first step in determining welfare exemption eligibility is to determine if the organization itself qualifies. In brief, an organization must meet the following requirements:

- It must be organized and operated for exempt purposes;
- It must not be organized or operated for profit;
- The owner organization must have an IRC §501(c)(3) or Revenue and Taxation Code 23701d letter of exemption;
- The user organization may also qualify with an IRC §501(c)(4) or Revenue and Taxation Code §23701f or §23701w letter;
- The organization's earnings must not benefit any private shareholder or individual;
- Articles of Incorporation must contain an acceptable statement of irrevocable dedication of the property to exempt purposes;
- Articles must contain an acceptable Dissolution Clause; and
- The property owner must be the owner of record on the lien date.

When the owners and operators of a property are different nonprofit entities, the property is not eligible for exemption unless both the **owner and operator** meet the specific requirements of Section 214. An operator is a user of the property on a regular basis, with or without a lease agreement. Typically, the owner and operator are one and the same and the filing of one claim for exemption will suffice. However, it is not

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necessary that the owner and the operator of the property be the same legal entity. If property is owned by one exempt organization and operated by another exempt organization, each must qualify and file a claim for exemption. If the operator is not an exempt organization meeting all the requirements of Section 214, the welfare exemption is not available on the property.

Specific Requirements for Use of Property. The Constitution and statutes impose a number of requirements that must be met before property can become eligible for exemption. Nonprofit organizations claiming exemption for their properties must satisfy various organizational requirements and must also meet additional requirements concerning uses of their property. With respect to the use of the property:

- The property must be used exclusively for exempt purposes.
- The property must be used for the actual operation of an exempt activity.²
- The property is not to be used to benefit any person through distribution of profits, compensation or the more advantageous pursuit of his or her business or profession.

Background

Related Legislation. AB 2662 (Bogh) of the 2002 Legislative Session would have amended Section 214.1 to specify that property already in the course of construction will not be considered “abandoned,” and therefore no longer eligible for exemption, if due to financing delays or delays in governmental approval. These provisions were removed from this bill by May 17, 2002 amendments.

Assembly Bill 1559 (Wiggins; Stats. 1999; Ch. 927) added Section 214.15 to the Revenue and Taxation code to provide a limited extension of the welfare exemption to vacant land. In this case the charitable purpose of the organization is acquiring and holding real property for the future construction/rehabilitation of single or multifamily residences for sale at cost to low-income families. Section 214.15 provides:

(a) Property is within the exemption provided by Sections 4 and 5 of Article XIII of the California Constitution if that property is owned and operated by a nonprofit corporation, otherwise qualifying for exemption under Section 214, that is organized and operated for the specific and primary purpose of building and rehabilitating single or multifamily residences for sale at cost to low-income families, with financing in the form of a zero interest rate loan and without regard to religion, race, national origin, or the sex of the head of household.

* * *

(2) With regard to paragraph (1), the Legislature finds and declares all of the following:

(A) The **exempt activities** of a nonprofit corporation as described in subdivision (a) **qualitatively differ** from the exempt activities of other nonprofit

² The exemption is limited to the amount of property reasonably necessary for the accomplishment of the exempt purpose. Portions of the property in excess of that reasonably necessary for the purposes of the organization do not meet the requirements for property tax exemption and are subject to taxation.

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entities that provide housing in that the exempt purpose of a nonprofit corporation as described in subdivision (a) is **not to own and operate** a housing project on an ongoing basis, but is instead to make housing, and the land reasonably necessary for the use of that housing, available **for prompt sale** to low-income residents.

(B) **In light of this distinction, the holding of real property** by a nonprofit corporation as described in subdivision (a), for the future construction on that property of a single or multifamily residence as described in that same subdivision, **is central to that corporation's exempt purposes and activities.**

(C) In light of the factors set forth in subparagraphs (A) and (B), **the holding of real property** by a nonprofit corporation described in subdivision (a), for the future construction on that property of a single or multifamily residence as described in that same subdivision, **constitutes the exclusive use of that property** for a charitable purpose within the meaning of subdivision (b) of Section 4 of Article XIII of the California Constitution.

COMMENTS:

1. **Sponsor and Purpose.** This bill is sponsored by The Traditional Values Coalition. According to the sponsor, this bill helps realize the overall purpose of the property tax exemption for charitable properties by expanding the definition of the term "course of construction." The sponsors note that "since the Revenue and Taxation Codes' property tax exemption for charitable properties was first enacted, the amount of time it takes to obtain land use and building permits has significantly increased. Current law does not provide enough time for an exempt organization to garner the necessary local, state, and federal permits to commence construction and still reap the benefits of the exemption. This inequity then subjects vacant land owned by the exempt organization, and intended for the exempt purpose, to property taxes." This bill "attempts to assist religious, hospital, scientific and charitable organizations from having to divert their financial resources from their designated purpose to paying property taxes. Unfortunately, while exempt organizations attempt to raise money for building expenses and to pay the fees and costs related to garnering approvals, they are also subject to property taxes because the land is vacant."
2. **May 12 Amendments.** The amendments changed the expansion of the phrase "in the course of construction" to include, but not be limited to, filing an application for a building permit, to narrow the scope of the bill. Previously, the bill expanded the phrase in the "course of construction" to include activities such as "seeking" permits, environmental studies, government entitlements and approvals, financing, and contractors. The prior language relating to the act of "seeking" these various activities was vague and undefined. The revised language limits the types of activities listed to applying for a building permit, but the phrase "includes, but is not limited to" leaves the application of that phrase open to different interpretations and does not definitively limit the scope of the bill. According to the author's office, future amendments are being proposed to delete this phrase and instead establish the

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application for a building permit to be a bright line test determining when the exemption can commence prior to actual physical construction.

3. **Generally, property is not eligible to receive the welfare exemption unless it is used by a nonprofit entity for exempt purposes and activities.** Historically, vacant, unused property held for future construction does not qualify for the welfare exemption since it is not being “used” for an exempt purpose and activity. Thus, unimproved land or vacant buildings or homes owned by the entity, are not qualified for the welfare exemption because the property is not being “used” for an exempt purpose and activity. The “use” requirement is usually a non-issue, since most exempt organizations that acquire property, generally start using it immediately. Therefore, the property of an otherwise qualified organization, is *not* exempt from property taxes between the period of time the property is initially acquired and the point in time where “onsite physical activity” commences. This bill would expand the welfare exemption to vacant, unused property that is held for future qualifying use. Currently, this property is not eligible for the welfare exemption.
4. **The Constitution does permit the welfare exemption to commence as soon as a building is “under construction.”** A relatively minor preparatory activity that results on physical changes visible to any person inspecting the site, such as grading vacant land or tearing down a building, can be undertaken for the purpose of complying with the requirement that the property be in the course of construction for purposes of qualifying for the property tax exemption.
5. **Section 214.2 would require amendment to avoid inconsistency with this bill.** Section 214.2 states that “definite onsite physical activity” is required for property to be considered “in the course of construction.” But this bill would not require that any physical construction take place to commence the welfare exemption. Consequently, conforming amendments are needed to correct this conflict.
6. **The sponsor notes that certain vacant property is eligible for the welfare exemption.** Specifically, Section 214.15 provides that vacant land acquired or donated to organizations, like Habitat for Humanity, for the future construction of a single or multifamily residence that will be sold at cost with zero interest loans constitutes the exclusive use of that property for a charitable purpose within the meaning of the California Constitution. However, in this situation the charitable activity of the organization is the acquisition of vacant land to construct homes that will subsequently become subject to property taxation upon acquisition by low income families. In contrast, most entities eligible for the welfare exemption are long-term owners of properties and the exemption from property taxation for their properties will likely apply indefinitely.
7. **This bill does not apply to property that qualifies for exemption under the college exemption or the church exemption.** It is possible that future legislation will be sought to similarly extend these provisions to those types of properties.

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COST ESTIMATE

The Board would incur some minor absorbable costs in informing and advising County Assessors, the public, and staff of the change in law.

REVENUE ESTIMATE

Background, Methodology, and Assumptions

The welfare exemption includes property that is used exclusively for religious, hospital, scientific, or charitable purposes and is owned and operated for those purposes by qualifying nonprofit organizations. Currently, the welfare exemption also applies to facilities under construction—along with the land on which the facilities are located—to be used exclusively for these purposes.

Under this bill, the course of construction would include undefined activities preparatory to actual construction, such as applying for a building permit. Staff estimates, based on information from several counties, that the approval process prior to actual construction takes, on average, about one year.

According to information obtained from San Bernardino and Santa Clara counties, the total value of property that currently does not qualify for the welfare exemption, but would qualify under this bill, amounts to \$70.2 million. This represents the total assessed value of several major properties that have been acquired by nonprofit organizations as either bare land or existing facilities that require modification.

The two counties account for nearly ten percent of the welfare exemptions in the state. Assuming those counties are representative for purposes of calculating a statewide estimate, multiplying the amount for the two counties results in the following estimate of the affected assessed value, if the course of construction were to include the activities that are preparatory to actual construction:

$$\$70.2 \text{ million} \times 10 = \$702 \text{ million}$$

Revenue Summary

If the course of construction were to include activities that are necessary for construction, this bill would reduce property tax revenues from the basic 1 percent property tax rate by about \$702 million x 1%, or \$7.0 million, annually.

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